REPORT TO THE SECRETARY OF THE TREASURY
FROM THE

TREASURY BORROWING ADVISORY COMMITTEE
OF THE
BOND MARKET ASSOCIATION

November 2, 2004

Dear Mr. Secretary:

Since the Committee's last meeting in August, GDP accelerated to a 3.7% pace in the third quarter and second quarter GDP growth has been revised higher to 3.3% from the originally reported 2.8%. Further, the latest economic readings point to a continuation of above trend growth during the fourth quarter. The ISM manufacturing report has moderated to 58.5 in September from the 20-year high reached in January, but it is still consistent with solid growth. The latest data also indicate that home sales remain near record high levels and will continue to do so given mortgage applications for purchasing new homes. Consumer spending grew just below 5% during the third quarter, despite declines in consumer confidence due to the uncertainty surrounding the outcome of the presidential election. The trend in payroll employment has moderated from this spring, with job gains averaging 112,000 per month in the third quarter. While this is weaker than payroll growth in the first two quarters of the year, it is stronger than a year ago when the US economy was still losing jobs. In addition, state level data indicates that job growth may have been temporarily suppressed in the third quarter by hurricanes and stands to rebound during the fourth quarter. The argument for a rebound is supported by jobless claims that have begun to decline again after increasing in July through September largely due to hurricanes. Oil prices rose significantly over the inter-meeting period. This has led to the potential for moderating growth.

Core inflation moderated in the third quarter after a significant acceleration during the second quarter. The core CPI rose an annualized 1.5% during the third quarter, following a 3.0% annualized increase in the second quarter. However, used cars, clothing, and lodging away from home accounted for the bulk of the second quarter acceleration. The core PCE deflator increased at only a 0.7% annual rate in Q3, bringing the year-over-year change in September to 1.5%, while the year-over-year change rose to 2.0% for the core CPI. Nonetheless, anecdotal information, the latest monthly data and the decline in the dollar imply significant increases in core inflation ahead. The persistence of higher energy and other raw material prices appear to have numerous industries in a position to try to pass through these higher costs in order to support earnings. Also, the dollar has declined against the euro, which has led a trade weighted dollar to depreciate over 3% from a year ago, suggesting a pick-up in import prices excluding food and energy.

After rising before the first FOMC tightening in June, long-term Treasury yields have declined over 50 basis points since the tightening cycle began. As the FOMC increased its short-term target by 75 basis points, a substantial flattening of the yield curve has ensued, even compared to previous tightening cycles of 1994 and 1999. However, the absolute spread between long- and short-term interest rates remains at historically high levels. Over the third quarter, 10-year yields fell by almost 50 basis points and the 2s/10s curve has flattened almost 50 basis points. Yields are currently 40 basis points higher than the lows observed in mid-March and the yield curve is 30 basis points flatter than its steepest levels of the quarter. The market is currently pricing in over a 90% probability that the Fed will raise rates by 25bp at the November FOMC meeting and is pricing in a funds rate of 2.00% by year end and roughly 2.50% by mid-2005.

Third quarter reported operating earnings appear to be showing signs of moderation after a strong acceleration over the past six quarters. Operating earnings have averaged approximately 6% growth on a quarter-to-quarter basis ending in the second quarter. Similarly, earnings have grown more than 20% on a year-to-year basis during this six-quarter period. Third quarter operating earnings likely fell slightly more than 2% from the second quarter, but are approximately 15% higher than the same quarter last year. As of Friday, October 29, 2004, 80% of the S&P 500 has reported earnings; approximately 77% have met or beaten expectations while 23% have failed to meet expectations. Slower earnings in financials, specifically insurance and brokerages and a temporary moderation of earnings in the consumer discretionary sector (especially automotive manufacturers) are largely behind the slowdown in earnings growth. Although a pick-up in economic activity supports stronger than expected earnings in the fourth quarter, the height of earnings acceleration appears to be behind us. Equity markets have been mixed year-to-date, although the most recent three months have experienced positive returns: the S&P 500 Index has risen approximately 1.6% year-to-date (+2.7% 3-months) and the NASDAQ composite has fallen approximately 1.4% year-to-date (+5.0% 3-months).

Against this economic and financial backdrop, the members of the Committee began consideration of debt management questions included in the Quarterly Charge. Following their standard format, Treasury presented a chart package that will be released as part of the Treasury refunding announcement.

The charge to the Committee was composed of two questions. In the first question, the Committee was presented with charts illustrating four overarching themes. They were: current financing needs, a description of the debt portfolio, the uncertainty of issuance and borrowing costs, and Treasury's position in the global and domestic capital markets. Members were asked to comment on these themes and indicate if they thought they accurately illustrate the major issues the Treasury faces.

The first section the Committee considered was Treasury's current financing. Treasury presented slides showing financing requirements, cash balances and quarterly net market borrowing from both marketable and non-marketable securities. They showed a slide illustrating the drivers of financing needs as well as slides which showed projected net marketable borrowing composition between coupon and bill issuance. These slides comprehensively portray all the salient issues to be considered and the Committee did not recommend further additions or changes.

The second section contained the description of the debt portfolio. Treasury presented slides which effectively depict debt maturity measures and the percentage of nominal debt maturing over the next three years. They also presented a chart of projected net market borrowing. Financing needs appear to be manageable. The distribution of marketable debt outstanding is balanced, and the percentage of debt maturing over the next 12-36 months is well within ranges observed over the past 20 years. The Committee did not suggest any further additions to this section.

The third section of the slide presentation, demonstrated the inherent uncertainty that Treasury faces in their issuance needs and borrowing costs. The Committee concurred that there is significant potential for forecast error in their projections. The group recommended that they continue to research ways to improve the large average forecast error. Despite the high possibility of variance as a result from forecast, the Committee was comfortable that the current issuance profile could easily facilitate higher or lower deficits.

The fourth and final section considered Treasury's sizeable role in both global and domestic debt markets. One slide presented showed foreign holdings as a percentage of total privately held debt and its current historically high level. Another showed the past and current dealer positions in treasuries. Interestingly, this slide showed both the growing acceptance by the investor base for TIPS as well as the lack of distinction of liquidity between TIPS and nominal securities by the primary dealer community. The willingness to sell short TIPS reflects increased end user demand and greater dealer confidence in accessing liquidity.

Many members commented on the improved quality of Treasury's portrayal of the thematic issues it faces. The Committee felt that Treasury has substantially improved its ability to communicate with investors through the slide presentations it has implemented in recent years. Members offered suggestions which they felt would further enhance Treasury's communication aims. A member urged Treasury to include disclaimers regarding forecasts and projections in their chart packets. Members felt that Treasury should include descriptive narrative to accompany some of the slides, thereby enhancing their view. It was also suggested by yet another member that Treasury should include a slide showing the duration of its debt which would compliment the slide which showed the maturity of its debt.

The second question of the charge related to financing recommendations for the quarter. The Committee addressed the question of the composition of Treasury notes to refund approximately $48 billion of privately held notes and bonds maturing on November 15th, 2004 (including $3.1 billion of the 10-3/8% 11/15/04-09 that was called on 7/15/04). The Committee further considered the composition of Treasury marketable financing for the remainder of the October-December quarter, including cash management bills if necessary.

Finally, the Committee considered composition of marketable financing for the January-March quarter to refund $48 billion of privately held notes and bonds maturing on November 15th, 200. The Committee recommended a $22 billion 3-year note due 11/15/07, a $15 billion 5-year not due 11/15/09, and a $14 billion 10-year note due 11/15/14. For the remainder of the quarter, the Committee recommended a $24 billion 2-year note issued in November and a $24 billion 2-year note issued in December, a $15 billion 5-year note issued in December and a $9 billion re-opening of the 10-year note in December. The Committee also recommended a $25 billion 12-day cash management bill issued 12/3/04 and maturing on 12/15/04. For the January-March quarter, the Committee recommended financing as contained in the attached tables. Relevant features include three $24 billion 2-year notes, a $22 billion 3-year note, three $15 billion 5-year notes, a $13 billion 10-year note in February followed by a $8 billion re-opening of that 10-year note in March. The Committee further recommended a $10-billion 10-year TIPS for issuance in January as well as a $6 billion re-opening of the 1/31/25 20-year TIPS in January.

Respectfully submitted,

Mark B. Werner
Chairman

Ian Banwell
Vice Chairman

Attachments (2)